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June 17, 2003

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 03-47, Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company, NSTAR Gas Company, Pension/PBOP Adjustment Mechanism Tariff Filing, Discovery Responses

Dear Secretary Cottrell:

Enclosed for filing in the above-referenced matter are the responses of Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company to the Information Requests set forth on the accompanying list.

Thank you for your attention to this matter.

Sincerely,

Robert N. Werlin / [illegible]

Robert N. Werlin

Enclosures

cc: Service List

Responses to Information Requests

Information Request AG-1-20

June 17, 2003

Information Request AG-1-20

Please provide copies of all of the Companies' filings and correspondence with the Department regarding the D.T.E. 02-78 deferral of pension and post-retirement benefits other than pensions costs.

Response

The Attachments are as follows:

- AG-1-20(1) – November 20 and November 22, 2002, Presentation to Department[1]
- AG-1-20(2) – November 27, 2002, Letter to Department requesting accounting ruling;
- AG-1-20(3) – December 9, 2002, Letter to Department Letter Requesting Extension of Time;
- AG-1-20(4) – December 11, 2002, Letter to Department Letter Requesting Extension of Time;
- AG-1-20(5) – December 12, 2002, Letter Requesting Extension of Time
- AG-1-20(6) – December 17, 2002, Letter to Department Responding to Attorney General; and
- AG-1-20(7) – December 17, 2002, Cover Letter and Motion For Leave To File Reply Comments

1 Attachment AG-1-20(1) is material provided at meetings that took place with the Department before the filing of the letter that was docketed as D.T.E. 02-78. However, because the subject matter concerned the issues that were the subject of the subsequent letter, the material is included. See also response to Information Request AG-1-21.

Massachusetts Department of Telecommunications and Energy

Pension & Other Postretirement Benefits Cost Accounting

NSTAR

11/20/02

The Pension Accounting Issue

- Throughout Corporate America three years of "bear" market losses have negatively impacted pension and other postretirement benefit funds.

- Accounting rules for pension plans (FASB #87) and postretirement benefits other than pensions (PBOP) (FASB #106), coupled with the highly unusual and unfavorable economic conditions of the last three years, are creating two unexpected and adverse results:

  - extreme volatility in annual reported utility pension and PBOP expense
  - large and unpredictable utility equity write-offs.

- These accounting impacts will weaken NSTAR's financial condition and lead to higher customer costs.

- A DTE accounting order can eliminate these harmful impacts while having no impact on current customer rate levels.

NSTAR Pension History

	95 – 99	00 – 02
Average Annual Return	19.7 %	(8.0 %)
Average Annual Expense (per FASB #87)	$ 27	$(3)
Average Annual Funding	$ 49	$ 48
Prepaid Balance	$ 108 (99)	$ 252 (02)

Conclusions

- Pension returns during the last 10 years have been in line with pension plan norms.
- Vagaries of FASB #87 accounting create illogical results, recording expense when stock market performed well and income as fund lost value.
- NSTAR has consistently funded the pension plan in excess of the $20m/yr collected in customer rates.
- Funding more than FASB #87 expense creates a prepaid balance.

NSTAR

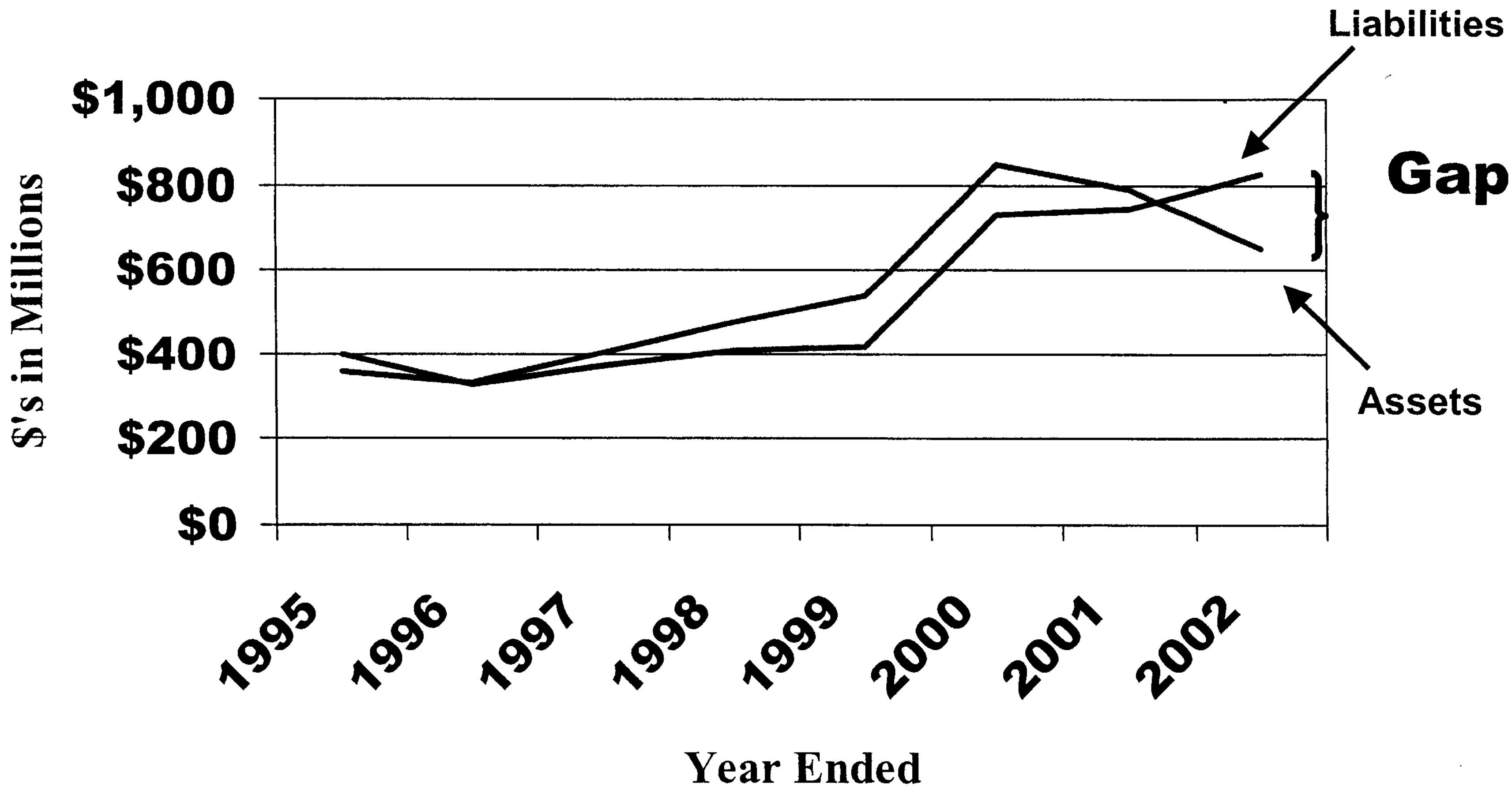
Pension Assets vs. Liabilities

	12/31/01	2002 Original Plan	Projected 2002
Assets (pension trust fund)	791	835	650
Liabilities (benefit obligations)	746	761	825
Excess (deficiency)	45	72	(175)
Discount Rate	7.25%	7.25%	6.75%

- Weak stock market performance combined with declining interest rates have created a deficiency this year.
- 2002 cash funding is at the IRS allowed maximum.

NSTAR

Pension Assets vs. Liabilities



NSTAR

Year-End Accounting
(without Accounting Order)

- Accounting for pension (FASB #87) requires NSTAR to record an additional minimum liability and to write off the prepaid pension balance at 12/31/02.

- Projected impact:

Liability greater than assets	$175
Prepaid pension on balance sheet	252
	$427
Taxes	(167)
Charge to equity	$260

- This write-off weakens the Company's balance sheet reducing common equity by 20%.

Impacts of the Equity Write-Off

- Utility bond ratings will be lowered.
- Cost of capital will increase. Credit agreements may be impacted.
- Labor union / Employee concerns
- Stock price will be negatively impacted.

NSTAR

Pension and PBOP History

	1993 – 2002 ($m)
Funding	$853
Cost (FASB #87/#106)	503
Amount in Rates	538

Conclusions

- Over the long-term, pension and PBOP costs are in line with rate levels.
- However, FASB #87 and #106 accounting results in volatile swings in annual costs.
- In 2003, FASB #87 costs are expected to increase 400% and FASB #106 costs are expected to increase 50%.

Proposed Accounting

- Set a "normalized" level of expense for pension and other postretirement benefit costs in next rate case.
- Record a regulatory asset in lieu of an "Other Comprehensive Loss"

- Defer any difference between the amount recovered in rates and the amount actually expensed for pension and PBOP trust funds to a regulatory asset or liability.

- Need DTE approval before 12/31/02 to avoid equity write-off.

NSTAR

Impacts of Accounting Order

- No change in current level of rates being charged to customers for pension and PBOPs.
- No change in NSTAR funding practices for pension and PBOPs.
- Order prevents significant equity write-off and normalize the book expense.

Massachusetts Department of Telecommunications and Energy

Pension & Other Postretirement Benefits Cost Accounting

NSTAR

11/22/02

The Pension Accounting Issue

- Throughout Corporate America three years of “bear” market losses have negatively impacted pension and other postretirement benefit funds.

- Accounting rules for pension plans (FASB #87) and postretirement benefits other than pensions (PBOP) (FASB #106), coupled with the highly unusual and unfavorable economic conditions of the last three years, are creating two unexpected and adverse results:
  - extreme volatility in annual reported utility pension and PBOP expense
  - large and unpredictable utility equity write-offs.

- These accounting impacts will weaken NSTAR’s financial condition and lead to higher customer costs.

- A DTE accounting order can eliminate these harmful impacts while having no impact on current customer rate levels.

NSTAR Pension History

	95 – 99	00 – 02
Average Annual Return	19.7 %	(8.0 %)
Average Annual Expense (per FASB #87)	$ 27	$(3)
Average Annual Funding	$ 60	$ 50
Prepaid Balance	$ 108 (99)	$ 252 (02)

Conclusions

- Pension returns during the last 10 years have been in line with pension plan norms.
- Vagaries of FASB #87 accounting create illogical results, recording expense when stock market performed well and income as fund lost value.
- NSTAR has consistently funded the pension plan in excess of the $21m/yr collected in customer rates.
- Funding more than FASB #87 expense creates a prepaid balance.

NSTAR

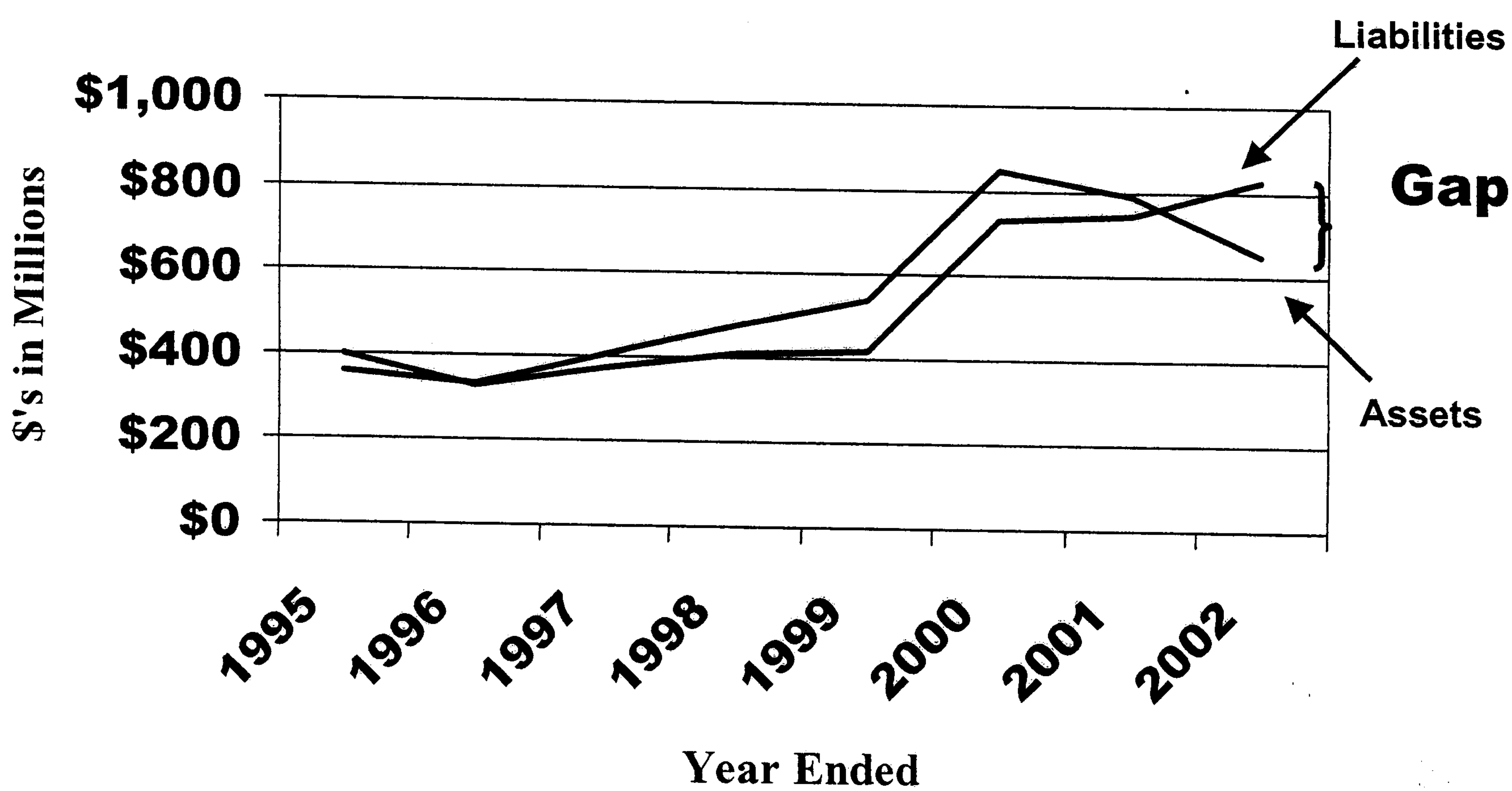
Pension Assets vs. Liabilities

	12/31/01	2002 Original Plan	Projected 2002
Assets (pension trust fund)	791	835	650
Liabilities (benefit obligations)	746	761	825
Excess (deficiency)	45	72	(175)
Discount Rate	7.25%	7.25%	6.75%

- Weak stock market performance combined with declining interest rates have created a deficiency this year.
- 2002 cash funding is at the IRS allowed maximum.

NSTAR

Pension Assets vs. Liabilities



NSTAR

Year-End Accounting
(without Accounting Order)

- Accounting for pension (FASB #87) requires NSTAR to record an additional minimum liability and to write off the prepaid pension balance at 12/31/02.

- Projected impact:

Liability greater than assets	$175
Prepaid pension on balance sheet	252
	$427
Taxes	(167)
Charge to equity	$260

- This write-off weakens the Company's balance sheet reducing common equity by 20%.

Impacts of the Equity Write-Off

- Utility bond ratings will be lowered.
- Cost of capital will increase. Credit agreements may be impacted.
- Labor union / Employee concerns
- Stock price will be negatively impacted.

Pension and PBOP History

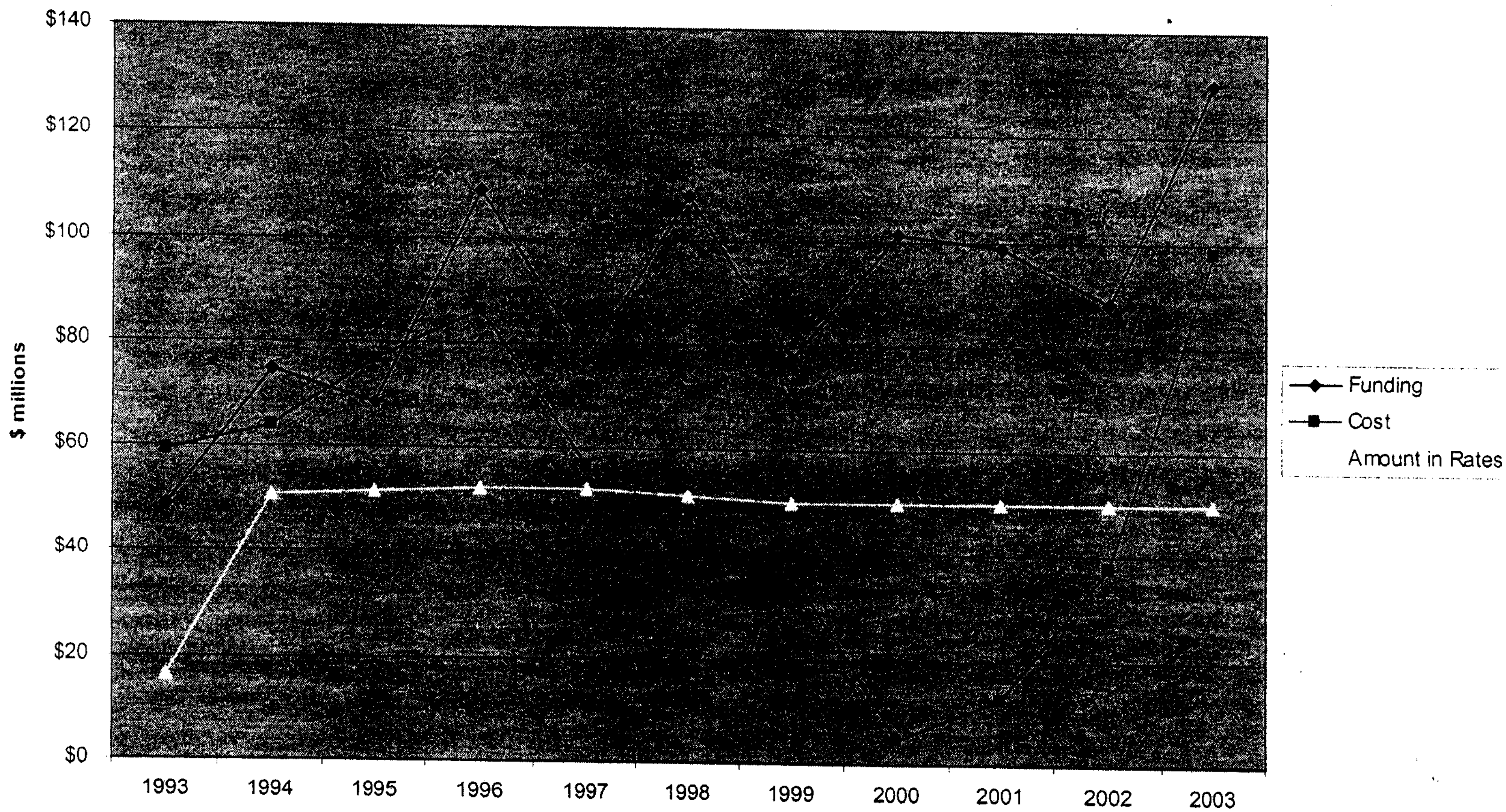
	1993 – 2002 ($m)
Funding	$853
Cost (FASB #87/#106)	481
Amount in Rates	474

Conclusions

- Over the long-term, pension and PBOP costs are in line with rate levels.
- However, FASB #87 and #106 accounting results in volatile swings in annual costs.
- In 2003, FASB #87 costs are expected to increase 400% and FASB #106 costs are expected to increase 50%.

NSTAR

Pension & PBOP



NSTAR

Proposed Accounting

- Set a "normalized" level of expense for pension and other postretirement benefit costs in next rate case.
- Record a regulatory asset in lieu of an "Other Comprehensive Loss"
- Defer any difference between the amount recovered in rates and the amount actually expensed for pension and PBOP trust funds to a regulatory asset or liability.
- Need DTE approval before 12/31/02 to avoid equity write-off.

Impacts of Accounting Order

- No change in current level of rates being charged to customers for pension and PBOPs.
- No change in NSTAR funding practices for pension and PBOPs.
- Order prevents significant equity write-off and normalize the book expense.

DTE Precedent

- Recovery of extraordinary, recurring costs
  - Fuel & purchased power posts
  - Environmental costs, D.P.U. 89-161
- Reconciliation of pension expenses to rates
  - Boston Edison rate settlement, D.P.U. 92-92
  - Boston Edison restructuring settlement
- Accounting orders on pension/PBOP deferrals
  - Boston Gas, December 1991 (D.P.U. 93-60)

Requested Accounting Order

- Until otherwise ordered by the Department, the Company will defer the difference between the level of the pension and PBOP expenses that are included in rates and the amounts that must be booked in accordance with FAS 87 and FAS 106.

- Until otherwise ordered by the Department, the Company will record as a regulatory asset the amount of its current and future Additional Minimum Liability to reflect the Company's ability to recover in rates over time its actual pension liability.

NSTAR 800 Boylston Street, Boston, Massachusetts 02199-8003

D.T.E. 03-47
Att. AG-1-20(2)

James J. Judge
Senior Vice President, Chief Financial Officer and Treasurer

November 27, 2002

Paul B. Vasington, Chairman
James Connelly, Commissioner
W. Robert Keating, Commissioner
Eugene J. Sullivan, Jr., Commissioner
Deirdre K. Manning, Commissioner
Department of Telecommunications and Energy
One South Station – 2nd Floor
Boston, Massachusetts 02110

Re: Accounting Treatment for Pension and Post-Retirement Benefits

Dear Commissioners:

Since 2000, the U.S. economy has experienced three consecutive years of significant equity-market declines coupled with falling interest rates. This unprecedented occurrence is having a considerable impact on NSTAR's obligations regarding employee pensions and post-retirement benefits other than pensions ("PBOP").[1] Consequently, by this letter, I am seeking the assistance of the Department of Telecommunications and Energy (the "Department") in mitigating the negative effects of certain accounting and ratemaking requirements that are implicated as a result of these unprecedented economic circumstances.

Over the past 10 years, NSTAR[2] has contributed an average of approximately $85 million per year into its trust funds specially established to hold and invest funds designated to pay pensions and PBOPs to retired employees. Over that same time period, the amount of pension and PBOP costs embedded in rates averaged only approximately $47 million per year. In accordance with Department policy, NSTAR has consistently made significant annual contributions to the pension and PBOP trust funds well in excess of the minimum levels required by the Employee Retirement Income Security Act of 1974 ("ERISA") and Internal Revenue Service ("IRS") regulations. Although this level of contribution greatly exceeded the level of expenses previously included in approved utility rates, NSTAR's funding policies ensured that trust funds were tax efficient and adequately funded so that benefits would be available to be paid to employees upon retirement.

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1 There are two accounting standards that have been issued by the Financial Accounting Standards Board ("FASB" or the "Board") that are germane to the Company's funding obligations for pensions and PBOPs. These standards are the Statement of Financial Accounting Standards No. 87 ("FAS 87") and No. 106 ("FAS 106"), which govern accounting practices for pension and PBOP expenses, respectively. The Board issued FASB 87 (Pensions) in December 1985 (effective in 1987) and FASB 106 (PBOPs) in December 1990 (effective in 1993).

2 For purposes of this letter, "NSTAR" or the "Company" refers to its regulated operating utilities, Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company and NSTAR Gas Company.

Despite these substantial contributions, NSTAR is now confronted with a serious accounting deficiency in its pension fund resulting from equity-market declines and falling interest rates. In combination, these factors have the dual impact of reducing the value of the assets held in trust to meet pension obligations, while at the same time increasing the benefit obligation (because a lower interest rate increases the present value of the benefit obligation to employees in the future).

Absent an accounting ruling from the Department, this shortfall will require NSTAR to record on its books a large non-cash charge to Other Comprehensive Income/Loss ("OCI"). Although the charge to OCI would be reversed in future periods, this charge to common equity would have an immediate and detrimental effect on NSTAR's financial health, and ultimately, the cost of service for NSTAR customers. For example, the Company's bond ratings are likely to be downgraded, which will increase the costs that the Company will incur to raise capital and finance utility operations. In addition, the Company's credit agreements may be negatively affected by this downgrading, which could further impair the Company's access to capital to continue financing system improvements and fund utility operations. The Company also anticipates that the situation would create concerns among employees and customers.

In addition, the expenses that will be booked under FAS 87 and FAS 106 in 2003 and forward will be significantly greater than the levels previously booked by the Company. Moreover, because changes in the position of the trust funds resulting from market volatility are captured in the IRS calculation of tax deductibility for fund contributions, the maximum for pension funds in 2003 is projected to be substantially greater than the $50 million per year that the Company has invested in the pension fund on average over the past five years.

The Department has consistently recognized that prudently incurred pension and PBOP costs may be included in utility rates. Given the volatility of these extraordinary and recurring expenses (whether viewed in terms of FAS 87 and FAS 106 expenses or tax deductible contributions), the Company will propose in a future proceeding a specific recovery mechanism designed to provide for the reconciliation between the amounts received from customers in rates and the FAS 87 and FAS 106 expenses recorded on the Company's books over a specified time period.[3] The approval of such a mechanism will ensure that the Company's customers pay in rates no more than the Company's actual pension liability, and the Company will collect only the actual amount of its actual pension obligation. Such a reconciliation is consistent with the Department's rate-continuity principles in that it will stabilize and smooth out the recovery of the

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3 Such treatment has been approved in similar circumstances by the Department in the past. See e.g., Boston Gas Company, D.P.U. 93-60, at 207-208 (1993); Boston Edison Company, D.P.U./D.T.E. 96-23 (1998) (approving Restructuring Settlement Agreement that provides that "post divestiture FAS 106 and FAS 87 gains or losses recognized on BECo's books shall be reflected in distribution rates to customers and shall neither be retained nor borne by BECo." Restructuring Settlement, at page 233, fn.5); Cambridge Electric Light Company, D.P.U. 92-250. at 54 (1993); Manufactured Gas Waste Generic Investigation, D.P.U. 89-161 (1990).

expense from customers, while avoiding adverse financial impacts. Without the approval of such a mechanism the volatility of pension expense and funding requirements, combined with the magnitude of these amounts, will significantly distort the annual reporting of the Company's operating results in the future and could result in the over-collection of costs from customers.

To avoid this result as well as the immediate and detrimental impacts associated with the year-end charge to equity of the Additional Minimum Liability ("AML"),[4] the Company requires an accounting ruling from the Department on or before December 31, 2002, that would permit, pending the establishment of the specific ratemaking methodology to reconcile and to recover costs, the deferral of the difference between the level of pension and PBOP expenses that are included in rates and the amounts that must be booked in accordance with FAS 87 and FAS 106, in recognition of the recoverability of these costs in future rates, as determined by the Department in the Company's next rate proceeding. Accordingly, the Company requests that it be authorized to implement the following accounting practices:

(a) until otherwise ordered by the Department, the Company will defer, and record as a regulatory asset or liability, the difference between the level of the pension and PBOP expenses that are included in rates and the amounts that must be booked in accordance with FAS 87 and FAS 106; and

(b) until otherwise ordered by the Department, the Company will defer as a regulatory asset the amount of its current and future Additional Minimum Liability to reflect the Company's ability to recover in rates over time its actual pension liability.

Thank you for your attention and consideration of this request.

Sincerely,

James J. Judge

James J. Judge
Senior Vice President,
Treasurer and Chief Financial Officer

cc: Joseph Rogers, Assistant Attorney General
Paul Afonso, General Counsel
Kevin Brannelly, Director, Division of Rates and Revenue Requirements

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4 The AML represents the amount by which the Company's pension plan obligations exceed the value of the assets in the trust fund at the end of each calendar year.

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December 9, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78

Dear Secretary Cottrell:

On November 27, 2002, Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company and NSTAR Gas Company (collectively, "NSTAR") filed with the Department of Telecommunications and Energy (the "Department") a request for an accounting ruling relating to pension and post-retirement benefits other than pensions. The Department docketed the request as D.T.E. 02-78 and solicited written comments to be filed no later than the close of business today.

Since that time, NSTAR and the Attorney General have been engaged in discussions with respect to the request, which could affect the comments, if any, that the Attorney General would offer. In order to conclude those discussions, NSTAR and the Attorney General hereby jointly request that the deadline for comments be extended by two days, until close of business on Wednesday, December 11, 2002.

Thank you for your attention to this matter.

Sincerely,

Robert N. Werlin

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
Alex Cochis, Assistant Attorney General

KEEGAN, WERLIN & PABIAN, LLP

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December 11, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78

Dear Secretary Cottrell:

On November 27, 2002, Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company and NSTAR Gas Company (collectively, "NSTAR") filed with the Department of Telecommunications and Energy (the "Department") a request for an accounting ruling relating to pension and post-retirement benefits other than pensions. The Department docketed the request as D.T.E. 02-78 and solicited written comments to be filed no later than the close of business December 9, 2002.

Since that time, NSTAR and the Attorney General have been engaged in discussions with respect to the request, which could affect the comments, if any, that the Attorney General would offer. On December 9, 2002, in order to conclude those discussions, NSTAR and the Attorney General jointly requested that the deadline for comments be extended by two days, until close of business on Wednesday, December 11, 2002. Since that time, discussions have continued, but not concluded. Accordingly, the Attorney General and NSTAR jointly request that the deadline for comments be extended an additional day, until the close of business on Thursday, December 12, 2002.

Thank you for your attention to this matter.

Sincerely,

Robert N. Werlin

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
Service List

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December 12, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78

Dear Secretary Cottrell:

On November 27, 2002, Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company and NSTAR Gas Company (collectively, "NSTAR") filed with the Department of Telecommunications and Energy (the "Department") a request for an accounting ruling relating to pension and post-retirement benefits other than pensions. The Department docketed the request as D.T.E. 02-78 and solicited written comments to be filed no later than the close of business December 9, 2002.

Since that time, NSTAR and the Attorney General have been engaged in discussions with respect to the request, which could affect the comments, if any, that the Attorney General would offer. On December 9, 2002, and December 11, 2002, in order to conclude those discussions, NSTAR and the Attorney General jointly requested that the deadline for comments be extended. Since that time, discussions have continued, but not concluded. Accordingly, the Attorney General and NSTAR jointly request that the deadline for comments be extended an additional day, until the close of business on Friday, December 13, 2002.

Thank you for your attention to this matter.

Sincerely,

Robert N. Werlin

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
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December 17, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78, Response of NSTAR to Comments of the Attorney General

Dear Secretary Cottrell:

On December 13, 2002, the Attorney General filed comments with the Department of Telecommunications and Energy (the "Department") concerning the November 27, 2002 request filed by Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company and NSTAR Gas Company (collectively "NSTAR" or the "Company") for an accounting ruling relating to pension and post-retirement benefits other than pensions ("PBOP"). NSTAR hereby files a response to the Attorney General.

In his comments, the Attorney General requests that the Department either deny the Company's request or allow for discovery and an evidentiary hearing to "fully examine the issues" prior to ruling on the request (Attorney General Comments at 1, 4). The Attorney General's recommendations are based solely on the claim that, under Department precedent, there is a "clear standard" that applies to the Company's requested accounting treatment and that, under this standard, the Company has "not demonstrated a prima facie case entitling it to a deferral" (id. at 2). As discussed below, the Attorney General's claim is flawed in that it misconstrues the nature and effect of the Company's request and rests on a misapplication of Department precedent.

As an initial matter, however, the Company would like to address the Attorney General's assertion that, although the denial of the Company's request could lead to detrimental financial consequences that may harm customers, the Department should deny the request or delay a ruling on the request because the Company has not shown that detrimental financial consequences "will in fact result" from a denial of the request (id. at 4).[1] The Attorney General's standard would effectively place customers at a

1 In this case, a delay by the Department in ruling on the request to allow for discovery and an evidentiary hearing is tantamount to a denial since the accounting entries must be made as of December 31, 2002.

significant risk of incurring increased costs of capital in the future, without any potential benefits or protections to offset that risk. It is widely recognized by credit rating agencies that a reduction in book equity will result in a higher debt-to-capital ratio, which, in turn, has negative implications on a company's ratings, and ultimately, the cost of borrowings. Attached is a September 12, 2002 article by FitchRatings, which discusses the impact of pension accounting on a company's financial health. Consistent with the statements made therein, a \$200-\$300 million charge against equity will significantly weaken the Company's balance sheet and reduce common equity by approximately 20 percent. The Attorney General does not dispute this fact, but rather claims that this type of significant reduction will not result in detrimental financial consequences for the Company. The Attorney General's assertion has no basis in fact and misrepresents the historical impact of this type of change in a company's capital ratios.

The Company routinely confers with the rating agencies and possesses the experience and expertise to know that, in the absence of the accounting ruling, the Company's bond rating will be immediately called into question. As the Department is aware, the Company recently received approval and intends to issue long-term debt of up to \$150 million for Commonwealth Electric Company. See, Commonwealth Electric Company, D.T.E. 02-51 (2002). The issuance of debt securities in the face of an impaired debt-to-equity ratio, will inevitably result in the debt being issued at a higher cost than without the equity charge. Moreover, the Company routinely relies on significant short-term debt instruments to fund day-to-day operations. These transactions will also be more costly as a result of the changed equity status of the Company. Therefore, denial of the accounting ruling has the potential to dramatically increase the Company's cost of capital and to increase the cost of service borne by customers. Thus, the Attorney General's argument that denial of the accounting ruling will have no negative impact on the Company or its customers is unfounded and erroneous and should be rejected by the Department.

In fact, because no change in rates would be instituted upon the Department's approval of the Company's request, customers can only be harmed by the denial or delay in the approval of the request. The Department's approval of the accounting treatment requested by the Company would preclude the unavoidable year-end accounting adjustments required of the Company, and therefore, eliminate entirely the potential for any detrimental financial consequences that would result in harm to customers. At the same time, as acknowledged in the Company's request, the Department's approval would leave open the underlying issues relating to the specific ratemaking methodology that would be used to recover pension and PBOP-related costs in the future. Therefore, as stated above, a decision by the Department to grant the accounting treatment would protect customers from the detrimental effects of the year-end accounting requirements, while preserving the Attorney General's ability to participate on behalf of customers in a future proceeding to establish the specifics of the cost-recovery mechanism before any change in rates is implemented.[2] Because customers have significant exposure if the request is denied or delayed, the Department should reject the Attorney General's request to deny or delay the request on the basis that the financial impact of a charge to equity of this magnitude cannot be precisely quantified.

In addition to understating the seriousness of the detrimental financial consequences that would result from a write-off, the Attorney General has applied a standard of review that is inapplicable to the Company's request. As discussed in detail below, the issues driving the Company's request are a function of unprecedented economic circumstances coupled with the constraints of the financial accounting and ratemaking processes, which have not previously been considered by the Department. As a result, the Attorney General's attempt to assert that any and all requests for accounting treatment coming before the Department are subject to the existing Department precedent, is misguided and should be rejected by the Department.

1. The Attorney General's Comments Misconstrue the Company's Request and Misapply Department Precedent.

The Attorney General's recommendation that the Company's request should be denied or delayed is predicated on the erroneous assumption that an accounting deferral that temporarily creates a regulatory asset must be limited to circumstances in which a company has incurred an extraordinary cost that would trigger a rate case in the absence of the Department's approval of the deferral.

However, it should first be noted that the Department issues accounting rulings pursuant to its general supervisory and ratemaking authority under G.L. c. 164, §§ 76 and 94. The issuance of an accounting ruling is not prescribed or constrained by statute or regulation either in relation to the process that is required to evaluate a request for an accounting ruling or the standard of review to be applied by the Department in evaluating such requests. To be sure, the majority of requests for accounting deferrals have involved the deferral of extraordinary expenses in a cost category included in base rates.[3] In the case cited by the Attorney General, North Attleboro Gas Company, D.P.U. 93-229 (1994), the Department explicitly stated that it was clarifying its standard for the review

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2 Such a proceeding would necessarily involve discovery and evidentiary hearings as requested by the Attorney General.

3 The genesis of many requests for accounting deferrals was the Department's order in Commonwealth Electric Company, D.P.U. 88-135/151, at 21-30 (1989) in which the Department denied recovery of pre-test year extraordinary storm expenses. Thereafter, it was clear that, absent an accounting ruling, if a company incurred a large expense for a cost category included in base rates, the expense could be recovered only if the year in which the expense was incurred was a test year. The Commonwealth case did not affect the deferral and recovery of cost categories subject to reconciliation mechanisms, e.g., fuel charge, cost of gas adjustment clauses, transition costs, environmental remediation costs.

of requested deferral accounting treatment for "extraordinary pretest year expenses." D.P.U. 93-229, at 7 (emphasis added). Thus, the Department's statements in D.P.U. 93-229 do not address the circumstances where a company may be seeking an accounting treatment for something other than the recovery of an extraordinary pre-test year expense. Significantly, NSTAR's request for a deferral is not based on the existence of an extraordinary pre-test year expense, and therefore, the Attorney General's arguments (and cited precedent) do not apply.

In this case, the driving factor underlying the Company's request for an accounting treatment is the existence of an unfunded liability in the pension trust combined with the existence of a sizeable prepaid asset account balance, which has resulted from the Company's longstanding practice of making cash contributions to the fund in excess of the annual expense booked in accordance with FAS 87 and FAS 106. Specifically, the Company estimates that, by December 31, 2002, the assets in the NSTAR trust funds will be reduced to approximately \$650 million and liabilities will be equal to approximately \$825 million as a result of equity-market declines and changes in interest/discount rates, representing an unfunded liability of approximately \$175 million.

As noted in the Company's request for an accounting ruling, this shortfall creates accounting issues for the Company that will have a significant negative impact on the financial health of NSTAR and the cost of capital used to fund utility operations on behalf of the Company's gas and electric customers. Specifically, FAS 87 requires that tax-deductible pension contributions in excess of the annual expense derived under FAS 87, are to be recorded as a asset (i.e., prepaid pension expense) on the Company's books. As of December 31, 2002, NSTAR will have a prepaid pension balance of approximately \$252 million resulting from the significant tax-deductible contributions made over the past several years in excess of the expense recorded on the Company's books under FAS 87. These contributions were made in accordance with the policy directives of the Department.

Under FAS 87, this prepaid asset must be written off the Company's books as of December 31, 2002 because a portion of the Company's pension obligation is now unfunded. Since the amount of the Company's pension obligation will exceed the value of the fund assets as of December 31, 2002, the Company must also recognize an "Additional Minimum Liability" equal to the difference between the pension obligation and the value of the fund assets. The "Additional Minimum Liability" must be added to the balance of the prepaid asset account and the sum total would be recorded on the

Company's books as a charge to common equity.[4] This charge to common equity will have the direct effect of reducing the Company's common equity on the balance sheet by $260 million (net of taxes), which represents a 20 percent reduction in the common equity of the Company.

In this case, the Company is asking the Department to allow the Company to defer, and record as a regulatory asset the amount of its current and future Additional Minimum Liability, which represents the "unfunded" pension obligation. The Additional Minimum Liability does not represent a not a single-year expense that would be included as a test-year expense in a rate case filing. The balance of the asset account will change as the asset value of the trust fund is affected by market conditions. Accordingly, the Company's request here is not the same as those deferral cases, like North Attleboro, that were designed to address the pre-test-year extraordinary expense disallowances that were raised by the Commonwealth case.

The Attorney General cites to Fitchburg Gas and Electric Light Company, D.T.E. 02-24/-2-25 (2002) in support of the claim that "neither the booked expense amount, nor the Additional Minimum Liability are recoverable under Department precedent" (Attorney General Comments at 2), and therefore, do not qualify for deferral treatment. However, the Attorney General is confusing the issue of the requested accounting treatment with the issue of the precise mechanism of how pension and PBOP costs are recovered through rates, which will not be determined as a result of the Department's approval of the Company's requested accounting ruling.

For example, there is no question that, prudently incurred expenditures made by regulated companies for pensions and PBOPs are recoverable in rates because such costs are incurred in order to provide service to customers. Under basic cost-of service ratemaking principles, rates are set to recover a representative level of the costs that are needed to serve customers. Thus, the challenge for the Department in setting rates to recover pension and PBOP costs has been in identifying the representative level of costs to be included in rates.[5] As noted in the Fitchburg decision, the Department has generally set rates to recover an average of annual cash contributions made by a company to its pension and PBOP trust funds. D.T.E. 02-24/02-25, at 110. Therefore, where a company

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4 In effect, these provisions of FAS 87 are designed to recognize that the Company's investment in the pension fund has been deteriorated by equity losses in the market. However, were the Department to allow the Company to defer the prepaid balance as a regulatory asset, as described below, the Company's investment would be effectively maintained until such time that additional cash contributions and market gains would mitigate the discrepancy between the value of assets held in the trust funds and the pension obligations.

5 This will be especially true given the current circumstances because the disparities between the FAS 87 and FAS 106 requirements for determining annual pension and PBOP expenses and the tax rules associated with the deductibility of cash contributions will be exaggerated over the next few years in light of the significant swings in the fund value that have occurred and may continue to occur as economic conditions fluctuate.

is able to demonstrate that it makes annual contributions to its pension and PBOP funds, the Department has typically included the average of the annual contributions in rates. Boston Gas Company, D.P.U. 93-60, at 234-235 (1993). At the same time, however, the Department has expressly refrained from establishing a set policy on the calculation of pension costs for ratemaking purposes and has consistently maintained that the intricacies of the issue warrant an investigation on a case-by-case basis. Boston Gas Company, D.P.U. 96-50, at 81 (Phase I) (1996), citing, D.P.U. 95-118, at 111; D.P.U. 95-40, at 44; D.P.U. 92-78, at 46. Therefore, the Department's historical practice of including cash contributions in rates does not mean that cash contributions are recoverable and booked expenses or the Additional Minimum Liability are not. It means only that the Department has, in the past, selected cash contributions rather than booked expenses as representative of the Company's annual pension cost in setting rates.

In any event, the accounting ruling that the Company seeks here would not predetermine the characteristics of the mechanism used to determine the amount of pension and PBOP costs that would be included in rates. The accounting ruling is intended only to avoid the adverse consequences that will otherwise result from a series of unprecedented market conditions that have created a temporary accounting deficiency in its pension fund, despite the aggressive funding policies of the Company. The creation of a regulatory asset as requested, will not limit the Department's right to review (nor the Attorney General's right to challenge) the prudence or reasonableness of expenditures or the precise way in which prudently incurred pension and PBOP costs are recovered from customers.[6] This is entirely consistent with the Department's long-held approach to the calculation of pension costs for ratemaking purposes, which allows for an investigation of the appropriate level of costs to be included in rates on a case-by-case basis in the context of a base-rate proceeding.[7] Moreover, the Company is not seeking any change in rates through this request, and any future rate change can be accomplished only with Department approval after full review and opportunity for hearing in a rate proceeding. Therefore, despite the Attorney General's assertions, the Company's proposal comports with Department practice and precedent, and in no way contradicts the Department's

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6 As the Attorney General points out, "the Company may elect to file a rate case as early as March of 2003 for effect after the expiration of the four year merger 'rate freeze' period" (Attorney General Comments at 2). Until that time, the rates charged to customers cannot be changed, nor will a ruling on the request for accounting treatment have the effect of making such a change. Thus, the Attorney General will have ample opportunity to address his ratemaking issues.

7 The Company is seeking to defer the difference between the level of pension and PBOP expenses included in rates and the amounts that must be booked in accordance with FAS 87 and FAS 106, as well as the amount of the Additional Minimum Liability, because Generally Accepted Accounting Principles ("GAAP") require the Company to book pension and PBOP obligations in a certain manner in order to qualify as a regulatory asset. However, this treatment does not dictate the structure of the ratemaking mechanism that the Department may adopt in a future proceeding to provide for the recovery of pension-related costs.

findings in the Fitchburg case, or any other rate proceeding conducted by the Department.

2. The Attorney General's "Reasons" for Denial Are Without Merit.

The Attorney General lists six reasons for the Department either to deny the request or to conduct an investigation prior to the issuance of the ruling (Attorney General Comments at 3-4). Although each of these is generally based on the mischaracterization of the request and misapplication of precedent as discussed above, in the interests of completeness and clarity, the Company will briefly address each issue separately.

> *"(1) The Company has not established that the "true-up" amount is an extraordinary operating expense that Department precedent would allow as proper for deferral, Boston Gas Company, D.P.U. 89-177, pp. 7-8 (1989), or that the costs are recoverable from customers in a subsequent rate case"* (Attorney General Comments at 3).

As discussed above, the nature of the Company's request is not one in which the Company is seeking to defer extraordinary pre-test year costs, and therefore, the precedent cited by the Attorney General is not controlling in this case. However, it is well established that pension and PBOP costs are recoverable from customers in rates. Given the unique economic circumstances affecting the Company's pension fund obligations and liabilities, the Company anticipates that cash contributions, booked expenses and the prepaid asset account will exhibit an unprecedented level of variability over the next several years. The Company's request is intended to preclude the detrimental financial impacts that would be associated with a significant common equity charge and to allow an opportunity for the Department to consider the ratemaking methodology that will be used to identify the appropriate level of costs to be included in rates. Although the Department's approval of the requested accounting treatment may have the collateral effect of delaying or eliminating the filing of one or more rate cases,[8] the Company's request is not predicated on that basis.

> *"(2) The Company has not established the level of pension and PBOP expenses in the Company's rates. The relevant rates of the distribution companies were fixed by settlement or rate cases that are as much as ten years old* [footnote omitted] *Several of the NSTAR companies rates were set in settlements; in the settled rate cases there are no Department findings on*

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8 As noted above, because of the Company now faces an unfunded obligation, the Company's cash contributions in 2003 and beyond will significantly exceed the expense level currently in distribution rates. Accordingly, denial of the requested accounting ruling will greatly increase the possibility that all four companies will need to seek rate relief next year.

> *the specific dollar amounts of individual costs, including pension and PBOPs"* (Attorney General Comments at 3).

The Attorney General is correct that determining the precise level of pension and PBOP expenses that are currently in the Company's rates is complicated by rate settlements as well as industry restructuring and generation asset divestiture. However, the deferral request is based on the accounting deficiencies and expenses that must be reported under GAAP, and the amount that has been or will be included in rates is a separate ratemaking issue that will be determined by the Department in a rate proceeding. The Company is not requesting such a ruling by the Department at this juncture, nor is it necessary for the Department to make a finding with regard to this issue.

> *"(3) The Company has not established that the pension and PBOP expenses cannot be changed from year to year simply by making minor changes in actuarial assumptions, thus directly affecting the regulatory asset balance"* (Attorney General Comments at 3).

Again, the Attorney General is raising an issue that is totally irrelevant to the request. To the extent that the actuarial assumption underlying the calculation of pension and PBOP expenses are subject to question at all, it would be only in the context of a ratemaking proceeding where the Department would be considering the appropriate level of costs to put into rates. In that regard, the Department has recognized that the calculation of pension and PBOP expenses for accounting purposes is dictated by FAS 87 and FAS 106, respectively. Western Massachusetts Electric, D.P.U. 87-260, at 44 (1988). The Department has further recognized that the adoption of FASB 87 and 106 made pension plan expense calculations less flexible. Id. Therefore, to the extent that the annual level of pension and PBOP expense is determined by actuarial assumptions regarding items such as future health care costs, mortality of employees and discount rates, the Company relies on independent, professional actuaries who prepare a report for the Company on an annual basis. This analysis is subject to review by the Company's outside auditors and, consistent with GAAP is based on various external indices and accounting conventions. Accordingly, the Attorney General claims in this regard should be rejected by the Department.

> *"(4) The Company has not established that any of the individual distribution companies will experience severe detrimental financial effects without the proposed deferral. In fact, NSTAR reported to the financial community an estimated \$200 – \$300 million impact of this accounting at end of the third quarter, yet the Company's bond rating has not changed, and the evidence does not show that the Company is having difficulty attracting capital. This transaction is not a cash outlay, rather it is an accounting accrual apparently recorded by the holding company"* (Attorney General Comments at 3-4).

In its most recent Form 10-Q filed with the Securities and Exchange Commission on November 27, 2002, NSTAR made the following statements in relation to the potential equity write-off:

> Assuming there is no significant change in interest rates or equity market performance for the remainder of the year, NSTAR anticipates that the after-tax charge to OCI will be approximately $200 million to $300 million
>
> ***
>
> NSTAR anticipates filing a request with the [Department] seeking an order to mitigate the non-cash charge to OCI and the increases in expected pension and other postretirement benefit costs and cash contributions. If approved, this request could potentially allow NSTAR to record a regulatory asset in lieu of a charge to OCI.

(Form 10-Q, at 9-10).

The fact that the financial markets have not yet reacted to the Company's indications on the pension-fund situation is not surprising, nor does it represent a signal that financial repercussions will not occur once the write-off is certain. The Company is under an obligation to disclose that a write-off may take place, but ratings agencies typically do not take definitive action until the event has actually occurred, especially where the Company has indicated that a resolution is being pursued through the regulatory arena. As a result, the fact that the Company's ratings have not yet been downgraded is not indicative of the consequences that will take place if the charge to common equity occurs.

> *"(5) The Company has not established the actual amount of the deferral and references stale data. The Company accounted for its pension and PBOPs trust fund assets for the most recently reported quarter, September 30, 2002. Since that time the stock market has risen 18 percent. The Company has failed to indicate what the expected deferral amount will be by December 31, 2002"* (Attorney General Comments at 4).

First, it should be noted that the Company's request would apply to the balance of the prepaid account as of December 31, 2002, as calculated using the most recent data available to the Company. Moreover, although the precise, final amount of the deferral cannot be known until after December 31, 2002, the change in the stock market is only one factor in the equation and, in fact, the recent rise in the stock market has had only a small impact on the overall position of the pension fund. Extremely low interest rates have also increased the Company's pension liabilities and these rates remain relatively unchanged. Taking account of the asset position as of the closing of the stock market on December 13, 2002, the charge against equity on December 31, 2002 is currently projected to be $253 million.

> "(6) *The Company indicated that this accounting problem is for the year 2002 and the situation will reverse in 2003. The Company, however, has not indicated what the Department should do if the situation reverses itself in 2003"* (Attorney General Comments at 4).

The Attorney General has misstated the Company's position with respect to the "reversal" of the accounting entries that, absent a favorable Department ruling, will occur as of December 31, 2002. Certainly, the economic conditions over the past several years that have precipitated the accounting deficiency are unprecedented and there is every expectation that, over time, more favorable market conditions will improve the performance of the pension and PBOP trust funds. The long-term funding of pensions and PBOPs that will eventually be collected from customers will fully benefit from improved market performance, but there is <u>nothing</u> that will reverse the immediate harm to the Company and its customers, absent Department approval of the accounting ruling. Moreover, it is the Company's intent to establish a mechanism that ensures that customers get the benefit of any reduction in costs associated with improved market performance in the future.

- **Conclusion**

For the reasons described above, the Attorney General's objections to NSTAR's request have no basis in fact or law. The request is narrowly framed to solve the immediate and potentially devastating financial accounting problem that has resulted from the convergence of a series of market events that are totally outside of the control of NSTAR. Approval of the request results in no adverse impacts to NSTAR customers, but avoids the serious negative effect of accounting conventions. Accordingly, the Department should dismiss the Attorney General's comments and approve the requested accounting ruling.

Thank you for your attention to this matter.

Sincerely,

Robert J. Keegan

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul G. Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
Service List

Enclosure

Corporates—U.S. and Canada
Special Report

Pensions in a Post-Bubble Economy

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■ Purpose

This report frames the pension debate within historical, legal and accounting contexts. It is intended to educate investors on both the historical trends and some of the accounting intricacies associated with defined benefit plans. It also highlights the most important issue for fixed-income investors, namely that it is difficult for anyone (outside of the company, its actuaries and certain government organizations) to determine a corporation's defined benefit plan cash-funding requirements utilizing public sources. This is an important issue for fixed-income investors who rely on these corporate cash flows to repay their debt.

This is the first piece in a series. Follow-up pieces will provide an overview of how Fitch Ratings views risk factors associated with pension issues and how Fitch incorporates them into the rating process. Additional pieces, written on an as-needed basis, will detail sectors and individual companies.

■ Terminology

For a short reference of pension terminology, please see the end of this report.

■ Overview

Corporate-defined benefit plans (hereafter referred to as pension plans) enjoyed excellent domestic stock market returns in the late 1990s. With annualized S&P 500 returns of 15.1% during the 1990s, more than 75% of companies in the S&P 500 Index had a pension surplus (defined as the fair market value of plan assets (FMV) minus the pension benefit obligation [PBO]) at the end of 1999. With assumed returns ranging from 8%–12%, corporations often far exceeded their expectations. Pension plan returns of more than 15% were not uncommon.

These surpluses resulted in two significant phenomena. The first phenomenon was that many corporations enjoyed "funding holidays." Simply put, they did not have to utilize cash to fund their existing pension plans. This improved cash flow helped buoy the domestic stock market, especially in industries focused on cash-flow generation. This created a somewhat self-fulfilling upward cycle.

The second phenomenon was that excess returns bolstered corporate operating income under the U.S. Generally Accepted Accounting Principals (GAAP). Corporations such as the General Electric Corporation (GE) and International Business Machines Corporation (IBM) generated more than 10% of pretax earnings from their pension plans. With surpluses drying up and market returns down, many companies will face an income shortfall that could alter their operating profile. These companies also face potential charges to comprehensive income (shareholder equity) resulting from their switch from a fully funded status to an underfunded status.

GE and IBM, however, are the lucky ones. Industries such as the automotive original equipment manufacturers (OEMs) and the airlines have much more at stake. Domestic OEMs, especially General Motors (GM), which has the largest retiree/employee base, face an additional business constraint that somewhat limits their operational flexibility and reduces their competitiveness when compared to foreign competition.

The airlines face an even more challenging environment as their underfunded pensions are hampered not only by negative asset returns, but also by the rapid acceleration of compensation increases. This pension situation could either magnify an already bad situation (i.e., United Airlines Inc. [UAL]) or significantly limit the financial/operational flexibility of somewhat stronger carriers.

An informative example of the second case is Continental Airlines Inc. (Continental), who recently contributed $150 million to its pension fund. This cash contribution reduces the amount of cash available to the operating business. Additional contributions will further constrain Continental's operational flexibility. This highlights how pensions can directly affect the overall credit profile of an issuer.

Underfunded pension obligations, as any other real claim on cash flow, are incorporated into Fitch's debt ratings. However, it is important to note that underfunded pension positions are a long-term consideration. Pension contributions do have an immediate effect on liquidity, but even substantially underfunded positions generally have years before the accounting gap and the funding gap converge. Managing to an underfunded position (typically to Employee Retirement Income Security Act of 1974 [ERISA] minimums or the avoidance of PBGC [Pension Benefit Guarantee Corporation] variable-rate premiums) can be part of a valid, healthy pension strategy.

The combination of underfunded positions and low (or negative) returns represent a meaningful claim on cash flows, draining capital that may otherwise be employed for productive investment. The problem, and its effect on corporate credit profiles, is likely to get worse before it gets better. In some cases, the effect may be more immediately felt through adjustments to shareholder equity, which, in some instances, could be multibillion dollar hits or result in debt to capital covenant defaults under bank agreements or bond indentures.

The U.S. Pension Framework

The Early Years of the Defined Benefit Plan

Private pensions have their origins in the rail industry of the 1870s. The railroad pension system arose out of concern about the continued employment of the industry's aging workforce. Initially, these older workers were placed in less physically demanding jobs such as night watchmen. As the rail industry (along with its workforce) matured, it became difficult to create these less-demanding jobs for its older workforce. The railroads turned to pension-like plans to allow them to retire their workforce while maintaining relative labor peace.

By the turn of the century, Yale, Harvard, Cornell and the University of California had established pension plans for retired faculty members. These pension plans, along with one founded by Andrew Carnegie (which is the predecessor of the Teachers Insurance and Annuity Association or TIAA), would start the spread of pensions that would lead to their further adoption by the banking and insurance industries in the second decade of the 20th century.

The Modern Pension

Two factors ultimately drove the more widespread adoption of corporate pensions. The first was the long-standing requirement to take older workers out of the workforce. This was especially true after World War II, when industry had mobilized both women and older workers to meet production demands. Without a pension system, employers faced potential labor unrest due to their inability to right-size their post-war workforce. Pensions provided employers with an opportunity to stabilize their workforce by removing older workers while maintaining labor peace. This stabilization effort has been especially important in heavily unionized segments of the U.S. workforce, as unions have shown significant ability to disrupt company operations.

The second factor was the adoption of the federal income tax in 1913. Under the original tax code, reasonable employer pension payments to retirees or contributions to trust funds were tax-deductible expenses for plan sponsors. Additional changes in the 1921 and 1926 Revenue Acts further perpetuated this favorable tax treatment, which, with only minor changes, continues to this day.

Factors Leading to the Adoption of ERISA

Several factors, many of which had been developing for years, drove Congress to put more stringent pension regulations in place. The first of these issues revolved around the handling of pension assets. One of the more infamous examples of the mishandling of pension assets is Jimmy Hoffa's abuse of the Teamsters Central States Pension Fund (CSPF) in the 1960s. Hoffa used the fund to provide loans to friends and received kickbacks in the form of brokering fees. By the mid-1960s many of these loans were in financial distress, thereby putting the CSPF-backed pensions at-risk.

Another factor in the formulation of ERISA was concern about the effect of bankruptcy on companies that had pension plans. Up until the creation of ERISA, companies had wide latitude in funding their pensions. Not surprisingly, companies that were forced to declare bankruptcy often had underfunded pensions. Employees who had staked their retirements on those employers were often left with little or nothing in return for their years of hard work.

A relevant example of the bankruptcy concerns was the collapse of automaker Studebaker. Declaring bankruptcy in 1964, Studebaker did not have adequate funds to cover accrued benefits. Retirees and those eligible to retire were provided annuities by the pension fund. Employees not eligible for retirement (they averaged 52 years of age and 23 years of service) received an annuity worth 15% of their vested benefits.

The final significant factor in the formation of ERISA was the ability of companies to alter their pension benefits at will. Employers often had contract language that allowed them to modify pension terms at will. Feeling that the pension was an implied contract, the federal government sought under ERISA to codify this contract. In return for their loyal service, employees were to be provided stability in their retirement.

ERISA

ERISA was put in place to provide additional safeguards for employees covered by privately defined benefit plans and was designed to prevent some of the abuses cited above. Passed by Congress and signed into law in 1974, ERISA has four titles:

ERISA's framework

Title I of ERISA deals with employee benefit rights. It addresses issues such as participation and vesting standards, plan funding, reporting and disclosure by plan sponsors, and the fiduciary duties of related parties. Two principal players share responsibility for enforcement of Title I. The Department of Labor is responsible for matters pertaining to reporting, disclosure and fiduciary regulation of plans. The Department of Treasury is responsible for the enforcement of participation, vesting and funding standards.

Title II of ERISA deals principally with tax matters and codifies the involvement of the Internal Revenue Service (IRS) as it relates to ERISA matters. In this regard, Title II also specifies minimum funding standards and provides for excise taxes (10%) on corporations failing to fund their plans in accordance with ERISA. Finally, Title II also liberalized self-employed pension plans (Keogh), created individual retirement accounts (IRAs), and modified other tax provisions related to retirement savings.

Title III of ERISA directed the creation of a Joint Board for the Enrollment of Actuaries. This organization provides for periodic assessments of pension obligations and assets as required under law. Member actuaries, who have been certified according to established standards, are authorized to sign the periodic reports as required under ERISA.

Title IV created the Pension Benefit Guaranty Corporation (PBGC), which serves as a pension benefit insurance provider. Set up within the Department of Labor, it serves to protect pensioners by, first, actively monitoring company compliance with appropriate pension legislation and, second, by guaranteeing the basic benefits, up to a limit, that are provided under plans that are terminated by their sponsors.

The PBGC

The PBGC was created by ERISA to protect the retirement income of private-sector employees covered by ERISA. It currently protects 44 million American workers in more than 35,000 defined benefit pension plans.

The PBGC currently pays monthly retirement benefits, up to a guaranteed maximum, to nearly 269,000 retirees in 2,975 pension plans that ended. Including those who have not yet retired, the PBGC is responsible for the current and future pensions of about 624,000 people.

The maximum pension benefit guaranteed by the PBGC is set by law and adjusted yearly. For plans ended in 2002, workers who retire at age 65 or older can receive up to $3,579.55 a month ($42,954.60 a year). The guarantee is lower for those who retire early or when there is a benefit for a survivor.

General tax revenues do not fund the PBGC. The PBGC collects insurance premiums from employers that sponsor insured pension plans, earns money from investments and receives funds from pension plans it takes over.

Congress sets PBGC premiums. The basic flat-rate premium is currently $19 per participant per year. Beginning in 1987, underfunded plans began to pay an additional variable-rate charge based on the level of unfunded vested benefits. The rate is currently set at $9 per $1,000 of unfunded vested benefits. Maximum total premium was originally set at $50 per participant per year, but as of the end of 1997 this cap has been eliminated.

The Pension and Welfare Benefits Administration (PWBA)

The PWBA is the agency within the Department of Labor that administers and enforces the provisions of Title I of the ERISA. In its efforts to enforce ERISA, the PWBA shares responsibility with the Department of the Treasury (Title I enforcement), the IRS (Title II enforcement) and the PBGC (Title IV enforcement).

In carrying out its enforcement responsibilities, the PWBA Pension conducts a wide range of activities, including civil and criminal investigations, to determine whether the provisions of ERISA and of the sections of Title 18, as they relate to employee benefit plans, have been violated. The PWBA field offices also provide assistance to plan participants and beneficiaries regarding their plan benefits.

Pension Accounting

While ERISA dictates how pension plans operate, pension accounting dictates how that operation is translated into a company's reported financial statements.

Accounting Mechanics

Pension accounting in the United States is principally governed by Statements of Financial Accounting Standards (SFAS) 87 and 88. These standards, determined by the Financial Accounting Standards Board (FASB), form the basis of U.S. pension GAAP. SFAS 87 is, by far, the more important of the two. (SFAS 88 deals with plan terminations and curtailments.)

SFAS 87

In order to understand pension accounting, it is necessary to understand the FASB's rationale in adopting SFAS 87. The following paragraphs, taken from the SFAS 87, provide the framework on which SFAS 87 is based:

"In applying accrual accounting to pensions, SFAS 87 recognizes three fundamental aspects that had been part of past pension accounting: *delaying recognition* of certain events, reporting *net cost,* and *offsetting* liabilities and assets. Those three features of practice have shaped financial reporting for pensions for many years, although they have been neither explicitly addressed nor widely understood, and they conflict in some respects with accounting principles applied elsewhere.

"The *delayed recognition* feature means that changes in the pension obligation (including those resulting from plan amendments) and changes in the value of assets set aside to meet those obligations are not recognized as they occur but are recognized systematically and gradually over subsequent periods. All changes are ultimately recognized except to the extent they may be offset by subsequent changes, but at any point changes that have been identified and quantified await subsequent accounting recognition as net cost components and as liabilities or assets.

"The *net cost* feature means that the recognized consequences of events and transactions affecting a pension plan are reported as a single net amount on the employer's financial statements. That approach aggregates at least three items that might be reported separately for any other part of an employer's operations: the compensation cost of benefits promised, interest cost resulting from deferred payment of those benefits, and the results of investing what are often significant amounts of assets.

"The *offsetting* feature means that recognized values of assets contributed to a plan and liabilities for pensions recognized as net pension cost of past periods are shown net in the employer's statement of financial position. This is despite the fact that the liability has not been settled, the assets may be still largely controlled, and substantial risks and rewards associated with both of those amounts are clearly borne by the employer.

"Within those three features of practice that are retained by this Statement, the Financial Accounting Standards Board (FASB) has sought to achieve more useful financial reporting through three changes:

- SFAS 87 requires a standardized method for measuring net periodic pension cost.
- SFAS 87 requires immediate recognition of a liability (the minimum liability) when the accumulated benefit obligation exceeds the fair value of plan assets.
- SFAS 87 requires expanded disclosures intended to provide more complete and more current information than can be practically incorporated in financial statements at the present time."

Pension Expense (the Income Statement)

Under SFAS 87, the reported pension cost reflects the utilization of a standard actuarial cost method. This *net cost* is the accumulation of several factors, including:

- Service cost
- Interest cost
- Amortization of transition assets/liabilities
- Amortization of gains and losses
- Amortization of prior service costs
- Expected return on assets

Of these factors, the first two (service and interest costs) are recognized in the year in which they occur and are hence unsmoothed.

The next three factors are, however, smoothed by amortizing them over a period of time (typically over the average service life of employees). An example of an item in these three smoothed categories would be the amortization of the cost of an amendment of the existing pension plan for the granting of additional pension benefits. In the case of GM, it routinely amends its pension plan to provide cost-of-living adjustments to its workforce.

The final factor, expected plan returns, is smoothed by utilizing both an assumed rate of return (versus the actual rate of return) and by amortizing the resultant gains/losses (expected returns less actual returns) over the average employee remaining service life. Beyond these well-recognized forms of pension asset return smoothing, there exists an additional form of smoothing. Known as market-related value (MRVA), this accounting option provides companies the option to recognize changes in asset values over a period of not more than five years. One common method of accomplishing this is the five-year-average-market-value method.

All of these forms of smoothing (which reflect the principal of *delayed recognition*) reduce the volatility of pension expense, but can lead to a situation where pension expense does not reflect the true economic situation. For example, for fiscal year 2001, GE reported pension income of $2.1 billion that included an assumed positive return on assets of $4.3 billion, despite the fact that actual pension plan performance was a loss of $2.9 billion.

One of the more interesting phenomena resulting from SFAS 87 surrounds pension income. Under SFAS 87, it is possible for companies to generate income via excess pension returns. When the expected return on plan assets exceeds the sum of all other five factors, then the company books pension income to the income statement.

Benefit Obligations/Plan Assets (the Balance Sheet)

Under SFAS 87, companies are required to report several important metrics designed to reflect plan status. These balance-sheet type metrics include:

- Projected Benefit Obligation (PBO)
- Accumulated Benefit Obligation (ABO)
- Fair Market Value of Plan Assets (FMV)

Companies are also required to reconcile these items with their balance-sheet accruals. These balance-sheet accruals reflect the difference between reported pension cost and contributions. Common differences include the unrecognized (or unamortized) pieces of pension expense that are smoothed under SFAS 87 (such as the difference between expected returns and actual returns).

If the ABO exceeds the sum of the balance-sheet accruals and the FMV, then companies are required to recognize an additional liability so the balance sheet reflects (on a net basis) the minimum pension liability. This minimum liability is intended to capture a portion of the pension funding deficiency as a claim on the firm's assets. Under SFAS 87, the effects of recording the additional liability are limited to the balance sheet. The additional liability set up is offset by recording an intangible asset and possibly a charge against Other Comprehensive Income (OCI). Most companies only show this charge in the separate OCI reconciliation, with the effect following through to the balance sheet as a part of a total change in OCI. Other companies, such as GM and Delphi Corporation (Delphi), show the effect in both OCI (similar to most companies) and on the balance sheet (by specifically excluding it from the OCI calculation and giving the liability its own line on the balance sheet).

These pension metrics are designed to provide stakeholders with a view of what the obligations are and whether or not company has sufficient assets (the FMV) to cover those liabilities.

The Missing Link (the Statement of Cash Flow)

SFAS 87 does not require significant disclosure surrounding the cash funding of corporate pension plans. Companies are required to state how much they contributed, but are not required to provide any information that would assist investors in understanding the basis for those contributions. This issue will be addressed later in this report.

Issues in Pension Accounting

Over the last several years, the following pension accounting issues have come to the forefront:

- The effects of a plan moving from overfunded to underfunded status
- Company selection of a rate of expected return
- The effect of recognition of market gains/losses on pension expense
- The determination of the discount rate

The Effects of Switching from an Overfunded Status to an Underfunded Status

One of the most interesting issues in pension accounting revolves around changes in a plan's funded status. This phenomenon has potentially dramatic balance sheet consequences.

An overfunded pension is likely to have a positive effect on the balance sheet and income statement (and therefore shareholder equity) due to the return on plan assets exceeding the service cost, interest cost, amortization of gains/losses and prior service cost. For example, in 1999 GE showed a net prepaid pension asset of $9.4 billion. By the end of 2001 this number, despite two years of poor plan returns, had escalated to $12.4 billion. GE accomplished this despite seeing a deterioration in its funded status of more than $10 billion (from $24.7 billion overfunded in 1999 to $14.6 billion overfunded in 2001). This was due in part to amortization of GE's unrecognized net gain from prior favorable experience. GE's unrecognized net gains decreased from $16.9 billion 1999 to $3.5 billion in 2001, primarily due to asset losses.

Should GE's plan returns continue to be poor, the unrecognized net gain will become an unrecognized net loss and the plan could move to underfunded status. If this were to occur, the prepaid asset would eventually disappear and GE's balance sheet would reflect an accrued liability.

An easily understood example of the potential effect of this scenario is Delphi. In 2001, Delphi took a $830 million charge (net of taxes) against OCI as a result of continuing deterioration in the pension plan.

The effect of a plan moving from overfunded to underfunded status can be lower book equity, resulting in higher debt to capital levels. Ultimately, this could lead to a negative rating action.

Expected Rates of Return

The next issue revolves around the selection of an expected rate of return on plan assets. Much has been made of this topic recently, with people like Warren Buffett commenting that companies are using overly ambitious levels of expected return.

Currently, companies have wide latitude in selecting their expected rate of return. Typical estimates for the rate of return range from 8%–10.5% with the average falling somewhere between 9.5%–10%.

Many investors have called these assumptions into question over the last two years, as stock market returns have been significantly lower than the 8%–10.5% range. It is important to remember, however, that this estimated return reflects the long-term returns of the diversified pension fund. Short-term swings in the New York Stock Exchange (NYSE) do not necessarily mean that a company should alter its expected rate of return. This is especially true given that pension funds benefit from diversification via ownership of equities (companies are prohibited by ERISA from having more than 10% of the pension fund's FMV in that company's respective stock or assets), fixed-income securities, private equity, real estate and other asset classes. The case that the performance of a single index does not accurately portray the diversified nature of pension funds is best exemplified by GM, which, in the first half of 2002, had a 3% loss in its pension fund. This compares with the Wilshire 5000 (perhaps the broadest benchmark of U.S. equities), which was down 12.7% during the same period.

It is relevant to note that the current market downturn marks the first instance of multiyear negative U.S. stock market performance (as measured by the major U.S. indices available throughout the period) since the passage of ERISA (in 1974). Combined with the fact that it takes a higher return to overcome a loss (for example, if you have a dollar and lose 10% it will take an 11.1% return to make it back to the original dollar), it is clear that many companies face their first real challenge resulting from sustained subpar market returns. As a result, Fitch believes that should the markets continue to underperform (relative to expectations) that most companies will have to lower their expected rate of return. On an accounting basis, this will result in higher pension expense, which reflects the economic reality that companies will have to make higher cash contributions to offset lower actual pension fund returns.

The Effect of Recognition of Market Gains/Losses on Pension Expense/Income

SFAS 87 allows companies to smooth the effect of pension plan asset returns on reported pension expense. This smoothing takes three forms.

The first of these forms is that FMV can be calculated using MVRA. This allows companies to smooth asset losses over a period of up to five years. This method could, in periods of significant negative market activity, smooth the resulting losses over a longer period. This artificially bolsters the asset base upon which the expected return is calculated.

The second form of smoothing is when the resulting pension expense is calculated using the expected rate of return (which may have been bolstered by use of MVRA) versus using the actual rate of return. This decreases pension expense volatility as it removes market volatility from the pension expense calculation.

Any differences between expected plan performance and actual plan performance are then amortized over a period of time (in this case the average remaining service life of the employee). This amortization of gains/losses is the final form of pension expense smoothing related to asset returns.

The net effect of these calculations is that companies may continue to show a low level of pension expense despite significantly negative actual asset returns. For example, GM showed only $146 million of net pension expense in 2001 despite the fact that the GM pension plan returned $11.9 billion less than anticipated (reflecting a $4.4 billion loss rather than a $7.5 billion gain). As these losses amortize, GM can expect to see significantly higher pension expense. In fact, GM currently estimates its 2002 pension expense at $1.1 billion. This increase in pension expense (due principally to lagging actual returns) would imply, all else being equal, significantly higher future cash funding requirements.

In addition to the potential to understate pension expense, SFAS 87 has created a system under which pension income can become a substantial contributor to reported earnings. Of note, in 2000 pension income was in excess of 10% of pretax income for 35 companies on the S&P 500.

For example, GE booked $2.1 billion of pension income in 2001 (representing 10.6% of pretax income). IBM booked $1.3 billion of pension income in 2001 (representing 12.2% of pretax income). This is made possible by the fact that both GE and IBM had overfunded pensions.

Most importantly, as a result of SFAS 87 smoothing, both companies reported these pension income figures despite the fact that their pension funds lost significant amounts of money in 2001. The difference between expected returns and actual returns for 2001 was $7.2 billion for GE and $10.2 billion for IBM. Although both companies will continue to report significant pension income in the near future, investors can expect the amount to decline significantly as the massive losses of 2000 and 2001 begin to outweigh the gains of the late 1990s.

The Determination of the Discount Rate

The discount rate is the most important obligation-related assumption in SFAS 87 reporting. Companies maintain significant latitude in their selection of this rate. Historically, companies have utilized a high-quality bond index (typically AA) to set their discount rates. Companies further modify this figure to reflect corporate culture/practice. Typical modifications include a reduction in the market benchmark by a certain percentage, utilizing an AAA benchmark or attempting to refine the benchmark by matching the maturity of their chosen benchmark to that of their pension liabilities.

The effect of the discount rate, and by association the corporate modifications to the standard AA benchmark, can be significant. A 1% change in this rate can increase/decrease a company's pension obligations by billions. For example, a 1% decrease in GM's assumed discount rate would add $7 billion to its pension obligations. It should be noted that this amount would be amortized over the average service life of the employees under SFAS 87's smoothing of actuarial changes. Conversely, a 1% increase in the discount rate would decrease GM's pension obligation by $7 billion.

A decrease in the discount rate would also result in higher pension expense. The interest cost component (discount rate times beginning PBO) of pension expense would increase due to the large increase in the PBO. This increase in PBO would outweigh the decrease in interest cost that would result from the decrease in the discount rate utilized in the interest cost calculation.

Although selection of a discount rate remains an issue in pension accounting (due to the oversized effect it can have), the discount rate is actually a more significant issue as it relates to ERISA/PBGC funding.

■ The Cash Funding of Defined Benefit Plans

The single most important issue for fixed-income investors is a pension plan's current and future claims on a company's cashflow.

Drivers of cash contributions

There are five principal factors that determine whether or not a company will contribute to its pension:

- Corporate funding policy
- Corporate funding capability
- Corporate tax position
- PBGC funding requirements
- ERISA funding requirements

Corporate Funding Policy

Perhaps the most important qualitative consideration in attempting to determine a company's future cash funding obligation is its funding policy. A company's funding policy will guide corporate decision makers through the funding process. The four most common funding policies are:

- Funding the plan to ERISA minimums
- Funding the plan to avoid PBGC variable premiums
- Funding the plan to the greatest extent possible within the existing tax code
- Funding the plan to ABO

There obviously exists a fifth option, namely not funding the plan, but that is viable only for a company that is in extreme financial distress (i.e., Chapter 7 bankruptcy).

Of these options, funding the plan to ERISA minimums is mandatory for companies that have privately defined benefit plans. Not only does ERISA mandate funding at this level, but many fixed-income investments (whether publicly traded debt, private-placement debt, or bank credit) have ERISA provisions that would put the borrower in default should the company fail to be compliant with ERISA.

The most common funding policy (beyond minimum ERISA funding) appears to be funding to avoid PBGC variable premiums. As a reminder, variable premiums are charged based on the aggregate amount of unfunded vested liabilities (based on PBGC's calculations). This premium effectively represents a tax on the corporation for its underfunded pension. By funding to this level the company not only avoids the premiums, but also retains significant flexibility (relative to the more stringent options of funding to tax capacity or funding to the ABO). Of note, it is more likely for mature companies to fund at this level as the percentage of vested obligations to total plan obligations is likely higher than a less mature company (reflecting a higher percentage of retirees). This means that a greater percentage of its obligations are eligible for consideration in calculating PBGC premiums.

Another common funding policy is to fund within the existing tax code. Under the highly complex U.S. tax code, only certain portions of pension contributions are deductible as an expense. Although Congress (with its passage of ERISA) wanted to encourage companies to fund private pensions, they put limitations in place to limit the resulting drain on federal revenues. These limitations, much like those that exist for IRAs, are designed to limit the amount of investments in tax-advantaged accounts.

Finally, it is possible that a company would choose to fully fund the ABO for its pensions regardless of the tax consequences. Fitch is not aware of a company that has adopted this strategy as it limits operational flexibility while also sacrificing viable tax benefits.

Of the five factors affecting cash funding, the funding policy can be one of the easiest to ascertain. Investors can consult either public filings (10-K or the annual report of a company's pension plan) or contact the company's investor relations staff to determine the corporation's policy in this matter.

Corporate Funding Capability

A corporation's decision to fund its pension is obviously based on its financial ability to fund the proposed contribution. Whether the contribution is cash or some other asset (such as equity in a publicly traded subsidiary), the company must consider the operational and financial ramifications of contributing to the pension plan. For example, it may be important in a recession to retain those funds for capital expenditures.

Of the five factors affecting cash funding, a corporation's ability to fund is probably the easiest to ascertain. Important factors would include cashflow metrics like free cash flow (can they afford to fund), balance sheet metrics like cash and other contributable assets (how they would fund), and qualitative metrics like debt ratings (what are the potential ramifications of their funding).

Corporate Tax Position

As stated previously, certain IRS limitations on pension contributions exist. Beyond these limitations, pension contributions would not be tax deductible. This situation is a significant factor in many companies' pension-funding strategy. This is especially true of companies that have larger funding shortages. These companies will usually contribute at the maximum level that will be deductible for tax purposes and will attempt to close the existing shortfall over longer periods. This assumes, of course, that they meet minimum ERISA and PBGC variable premium requirements (which might cause them to close the gap quicker to avoid the excise tax and/or variable premiums).

Above and beyond this limitation on tax deductibility, there exists complexities within a company's tax situation that might encourage/discourage it to fund the pension in a given period. For example, all else being equal, it is logical that high-rate taxpayers such as Phillip Morris Companies, Inc. (Phillip Morris) and GE would be more likely to fund their pensions to the maximum level of tax deductibility. Likewise it is likely that lower rate taxpayers, as long as they remain within ERISA and PBGC guidelines, would fund their pensions less aggressively.

Of the five factors affecting cash funding, the tax situation is perhaps the most complex factor. Not only do investors have to consider the company's tax situation (as it relates to both the deductibility of the contributions and the company's overall tax position), but investors must also determine the importance of this factor within the framework of the other four factors.

Investors must weigh the tax factor within the confines of the other four factors because the tax situation is merely a question of money. Should the financial consequences of not funding (such as payment of excise taxes or PBGC premiums) exceed the tax consequences of funding (i.e., the inability to deduct contributions for tax purposes), then the corporation would obviously fund regardless of the tax effect.

PBGC Funding Requirements

The PBGC requires corporations to fully fund their vested pensions (as defined by the PBGC) or face variable premiums (currently $9 per $1000 of unfunded vested liability) on top of their existing standard premium (currently $19 per person per year). Although PBGC's funding requirements are simple to understand, the metrics utilized to determine a corporation's funded status are not.

This complexity is partially due to the different focus of the PBGC. As an insurer, PBGC is most concerned with the current obligations of the company's pension plan as represented by an immediate plan termination resulting from a bankruptcy. Under this scenario, the company's current obligations are best represented by the Vested Benefit Obligation (VBO). This is because the VBO best represents the obligations of the PBGC to insured pensioners, namely the expectation that they receive the benefits they have earned to date. This compares to both SFAS 87 and ERISA, both of which have a "going concern" focus (i.e., the company will stay in business indefinitely). This differing assumption assumes that the obligation reflects not only what former/current employees have earned, but also what they are expected to earn during their careers.

As a result of this focus on the immediate situation, the PBGC also uses a different discount rate. This rate is currently set by the IRS in accordance with guidance codified under the ERISA legislation, based on 100% of the yield on 30-year Treasury bonds (and is updated periodically).

As a result of these differences, a lack of expertise at many companies (which have outsourced pension issues to consultants) and a general lack of public disclosure of actuarial assumptions, it is effectively impossible for investors to determine whether a company is fully funded as far as the PBGC is concerned. As a result, investors are basically reliant upon the company for disclosure on this issue.

ERISA Funding Requirements

ERISA funding requirements are mandated by Section 1082 of the ERISA portion of the U.S. Code. Under this section, each plan has a funding standard account. This account is both charged and credited with certain items. The most important charges are the normal costs of the plan for the plan year and amortization of the "unfunded current liability" (as measured using the "current liability interest rate," yet another discount rate based on the 30-year Treasury yield). The most important credit is the amount considered contributed by the employer for the plan year.

The funding standard account is then analyzed to determine if there is a deficiency. This includes both deficiencies within the current plan year and deficiencies within the total plan (i.e., accumulated plan deficiency).

One of the funding requirements is that should the pension plan fall below a 90% funding level (based on the ERISA definition of "current liability") on an overall basis, then the company would be required to contribute toward the unfunded current liability. An exception, however, exists. Companies that fall below 80% but were above 90% funded in two consecutive prior years out of the last three are not required to fund under the current liability requirement. This contribution would, once again, be based on a complex set of formulae.

Under all circumstances, if a deficiency exists the employer is required to contribute within certain complex guidelines. These guidelines enable a company to return to a fully funded status over a period of time. The Retirement Protection Act of 1994 shortened the period of time a company has to return to a fully funded status. Failure to make required payments will result in liens being placed upon a company's real and personal property.

One significant factor in many corporation's ERISA situation is what is commonly referred to as "ERISA credits." These credits represent an accumulation of overfunding by the corporation. This is the result of a company contributing beyond its required funding requirement in previous years. This effectively represents the opposite of an accumulated plan deficiency. An example would be GM, which has accumulated in excess of $20 billion of ERISA credits. This enables GM, despite a level of underfunding projected to exceed $13 billion in 2002, to avoid cash contributions under ERISA until 2006.

Due to the complexities of the U.S. Code governing ERISA, it is challenging to determine the required ERISA funding requirements for a corporation. This difficulty is magnified by factors such as administrative decisions made by people like the Secretary of the Treasury and by a lack of knowledge of the underlying actuarial assumptions made by the corporation. Much like the PBGC variable premium funding rules, investors are heavily reliant on the company for disclosure on ERISA funding requirements.

If I Cannot Figure It Out For Myself, What Do I Do?

Due to the complexities surrounding the PBGC, ERISA and corporate disclosures, it is effectively impossible for investors to determine cash pension funding requirements. Does this mean that investors are helpless? The simple answer is no.

Investors have several tools to gauge the potential magnitude of future cash pension contributions. Investors should be familiar with the industry. This includes the workforce (is it unionized?) and its history. Investors should look at prior pension contributions and compare these to the financial statements provided since the adoption of SFAS 87. Special attention should be made to plan amendments such as those utilized by the domestic OEMs after each labor contract. Although pension accounting can not serve as a basis for determining required cash contributions, it is directionally correct in that any company that has a large underfunded pension will have to contribute significantly at some point in the future. It is simply an issue of timing.

Finally investors should look for company statements on the pension issue and should feel free to query the company on what its future obligations might be. These statements would include:

- Press releases
- Public disclosures such as 10-Ks, 10-Qs, annual reports, analyst meetings and conferences
- Pension related documents such as PBGC filings, annual pension reports and Form 5500 filings (some of these would probably require Freedom of Information Act filings)

Conclusion

It is clear after several years of poor asset returns that investors' attention has returned to the subject of pensions. This is not surprising, as many companies are dealing with consecutive negative annual returns for the first time. Although many companies are attempting to downplay the significance of the last two years, it is important to remember that in order to reverse this pension asset trend actual returns must not just turn positive, but will need to be sufficient to adequately fund future obligations as well.

Although pension accounting (as codified by SFAS 87) provides significant useful information, it is very limited in its ability to assist fixed-income investors. SFAS 87's combination of noncash focus and its basis in "going-concern" accounting limit the investor's ability to gauge the effect of the five factors that drive the cash funding of pension plans. In the end, the investors ability to assess both the qualitative factors surrounding corporate culture (funding policy) and the quantitative factors surrounding ERISA and PBGC funding mechanics, are limited by both a lack of public disclosure and a burdensome system of overlapping and inconsistent regulatory requirements. As a result, fixed-income investors are basically reliant on the companies for information.

Although this report has focused on private pensions, investors need to realize this issue is not limited to private pensions. More than 50% of public pensions are currently underfunded. Social Security, the greatest defined benefit plan in history, is essentially unfunded (as it is a pay-as-you-go system). This issue, even if it has slipped below the radar screen for the latter half of 1990s, is not going away.

Terminology

A basic understanding of the terminology associated with defined benefit plans is necessary to fully comprehend the issues surrounding pension funding.

It is also important to note that in many instances the amortization periods differ pension accounting (SFAS 87) and legal funding requirements (ERISA). In most cases, pension accounting is amortized across average remaining service life, whereas amortization periods for government funding requirements are determined by law. Should questions on what time period to use for accounting purposes arise, Fitch suggests consulting SFAS 87 (can be ordered from the FASB website at www.fasb.org). For ERISA funding requirements, consult the U.S. Code Collection at the Legal Information Institute (specifically Title 29, Chapter 18, Subchapter I, Subtitle B, Part 3, Section 1082—Minimum funding standards, available at www.cornell.edu/uscode/29/1082.html)

Terms

Accumulated Benefit Obligation (ABO)—The present value of pension benefits earned as of the balance sheet date based on current salaries. This figure represents the plan's obligations assuming the plan provides no additional benefits based on future pay or service with the employer. This item must be reported in financial reporting footnotes.

Actuarial Gains and Losses—The change in PBO resulting from changes in one or more actuarial assumptions such as quit rates, retirement dates, mortality, the discount rate or from actual experience differing from those assumptions.

Amortization of Gains and Losses—Actuarial gains/losses and gains and losses representing the difference between expected and actual return on assets are deferred and accumulated. When total deferrals exceed 10% of the larger of the PBO and the market-related value of the plan, these deferrals must be amortized over the average remaining employee service life. This is known as the "corridor method" and is the minimum permitted under SFAS 87. The amounts are recalculated each year. Faster amortization is permitted, but the method used must be consistent.

Amortization of Prior Service Cost—Prior service cost is not expensed as it is incurred, but is instead amortized over the average remaining service life of affected employees. It is a component of reported pension cost.

Amortization of Transition Asset or Liability—Adoption of SFAS 87 generated either a transition asset or liability. The difference between the previous accrual and the economic status of the plan (PBO less the Fair Market Value of Plan Assets) is the amortized value over the average remaining service life of the employees.

Average Remaining Service Life of Employees—The expected average remaining service period of employees prior to retirement of current plan participants.

Benefits Paid—Benefits paid to retirees, thereby reducing the PBO.

Change in Benefit Obligation—Equals Service Cost plus Interest Cost plus (or minus) Actuarial Gains/Losses plus (or minus) Prior Service Cost less Benefits Paid.

Change in Plan Assets—Equals return on plan assets plus contributions less benefits paid.

Defined Benefit Plan— A plan that pays a defined benefit upon retirement to employees. This amount may be paid as a lump sum or as monthly payments per period to the employee during their retirement period (i.e., $1,000/month). This amount is usually calculated based on one of two approaches. The first of these methods is the so-called flat-benefit plan. This plan takes the form of a formula such as $50 per month for each year worked. The second method is the so-called pay-related plan. Pay-related plans tie the benefit to the level of employee earnings, with benefits usually based on either final salary (such as an average of the last three years prior to retirement) or a career average salary. The single most important characteristic of defined benefit plans is that the sponsor (employer) bears the investment risk.

Discount Rate—This rate drives the benefit obligation. In theory, it is the estimated purchase rate that would be used by insurance companies to satisfy the liabilities via an annuity. In practical application, it is the rate assumed for the future interest costs used to determine pension cost and is the discount factor used in determining the net present value (NPV) of both the PBO and the ABO. For purposes of SFAS 87, it is currently modeled on high-quality (AA) corporate bonds. As it relates to ERISA, the "current liability interest rate" has historically been modeled on the 30-year Treasury bond, although there is concern that this is no longer a valid benchmark given the government's de-emphasis of that instrument in recent years. This rate is required (by Title 29 of the U.S. Code) to be within a range (currently 90%–120%) of the weighted average of 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year. Due to the lack of new 30-year Treasury bonds, the IRS has recently assumed the role of issuing the current liability interest rate for ERISA calculations. The PBGC provides the rate for PBGC funding calculations.

Employer Contributions—Amounts contributed via cash or other assets to fund the company's benefit obligations.

Expected Return on Assets—The company's estimate of the long-term return on plan assets. This figure is used to determine the reported pension cost. Use of the less volatile expected return (when compared with the discount rate) has the effect of smoothing pension cost.

Fair Market Value of Plan Assets (FMV)—Represents the fair value of the pension plan's assets.

Gross Pension Cost—Equals the change in PBO excluding benefits paid. Equals service cost plus interest cost plus/minus actuarial gains and losses plus/minus prior service cost.

Interest Cost—The increase in future pension payments due to the accumulation of interest associated with the discount rate. In calculating interest cost, reported pension cost is calculated using projected benefits (i.e., the plan continues), not accumulated benefits.

Minimum Liability Adjustment—Plans where the ABO exceeds the sum of balance-sheet accruals and FMV are required to recognize the shortfall on the balance sheet as a minimum liability.

Nonsmoothed Pension Cost—Equals the gross pension cost plus (or minus) actual pension returns. A more volatile measure of pension cost, as it reflects actual pension-plan returns, gains/losses and prior service costs (not long-term smoothed averages).

Pension plan—See Defined Benefit Plan.

Prior (or past) Service Cost—A new obligation or an increase in an existing obligation as the result of the initiation of a new plan or an amendment to an existing plan.

Projected Benefit Obligation (PBO)—The present value of pension benefits earned as of the balance-sheet date, including projected salary increases for career average of final pay plans. This estimated obligation reflects the understanding that the company will be a "going concern," and is required under SFAS 87 to be reported in financial reporting footnotes.

Rate of Compensation Increase—An estimation of future salary growth used to calculate the PBO. It must be economically consistent with other assumptions and reflect the company's practice. For example, high inflation (as indicated by the discount rate used) and low salary growth cannot be projected. It is required to be disclosed under SFAS 87.

Reported Pension Cost (pension cost or net periodic pension cost)—Reflects the sum of the current year's service cost, interest cost, expected return on assets, the amortization of gains and losses, the amortization of prior service costs and the amortization of transition assets/liabilities. This figure is required to be recognized and disclosed in financial reporting under SFAS 87.

Return on Assets—The actual return on a pension fund's assets.

Service Cost—The annual cost of benefits earned by the employee for an additional year of service. This represents the present value of the incremental retirement benefits earned by employees in the current year. In calculating service cost, reported pension cost is calculated using projected benefits (i.e., the plan continues), not accumulated benefits.

Statement of Financial Accounting Standards 87 (SFAS 87)—This standard, adopted in 1985, prescribes how pension obligations and costs are to be measured and recognized. It requires disclosure of key assumptions used to compute pension obligation and pension cost. Finally, it requires a detailed reconciliation with the balance-sheet accrual.

Statement of Financial Accounting Standards 88 (SFAS 88)—This standard, adopted in 1985, prescribes employers' accounting for settlements and curtailments of defined benefit pension plans and for certain termination benefits.

Statement of Financial Accounting Standards 132 (SFAS 132)—This standard, effective beginning in 1998, prescribes the disclosure of pension-related information. It does not change the calculations or measurements dictated by SFAS 87 and 88.

Vested Benefit Obligation (VBO)—The present value of all benefits earned to date assuming all employees decide to terminate as of the balance-sheet date.

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December 17, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: NSTAR Electric Company/NSTAR Gas Company, D.T.E. 02-78

Dear Secretary Cottrell:

Enclosed please find a Motion for Leave to File Reply Comments in the above-captioned matter.

Thank you for your attention to this matter.

Sincerely,

Robert J. Keegan

cc: Caroline O'Brien, Hearing Officer (seven copies)
Paul Afonso, General Counsel
Joseph Rogers, Assistant Attorney General
Service List

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

NSTAR Electric/ NSTAR Gas Company	)	D.T.E. 02-78

MOTION FOR LEAVE TO FILE REPLY COMMENTS

Pursuant to 220 C.M.R. § 1.04(5), Boston Edison Company, Cambridge Electric Light Company and Commonwealth Electric Company d/b/a NSTAR Electric, and NSTAR Gas Company, (collectively, "NSTAR" or the "Company") hereby move the Department of Telecommunications and Energy (the "Department") for leave to file reply comments in the above-captioned proceeding. In support of its Motion, the Company states the following:

1. On November 27, 2002, NSTAR filed a request for an accounting ruling related to pension and post-retirement benefits other than pensions.

2. Subsequently, the Department issued a Notice wherein it required interested persons to file comments on the Company's proposal by December 9, 2002. Upon the joint request of NSTAR and the Attorney General, the date for submission of comments was deferred until December 13, 2002. The Department's Notice did not establish a date for the Company to submit Reply Comments.

3. On December 13, 2002, the Attorney General submitted comments.

4. In his comments, the Attorney General raised issues concerning the Company's petition that are either erroneous or require clarification by the Company.

5. In an effort to provide the Department with accurate information about its petition, good cause exists for allowing the Company to respond to the Attorney General's comments. Allowing the Company to file its Reply Comments (attached hereto) will not delay the proceeding.

WHEREFORE, for the reasons stated above, the Company respectfully requests that this Motion for Leave to File Reply Comments be granted.

Respectfully submitted,

NSTAR ELECTRIC/NSTAR GAS COMPANY

By its attorney,

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